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Why It's Difficult To Change Regulation

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INDEX TO PRI PUBLICATIONS

(6)

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(10)

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WHY IT'S DIFFICULT TO CHANGE REGULATION

Economists, as a group, do not seem to find much good to say about regulation as it is practiced. They do studies demonstrating that it leads to inefficient production and diminished services and forces some customers (usually poorer ones) to subsidize others (usually richer ones). They also assert that it restricts innovation, and generally, works <u>against</u> achievement of most of the objectives used to justify its adoption in the first place. So far as economists are concerned, desirable changes in regulation are mostly negative; they would like to do away with it.

OBSTACLES TO CHANGE IN REGULATION

Rather than going through the familiar arguments about why regulation should be changed, the author I am going ~~to~~ focuses on the factors that prevent desirable changes in regulation from being made. There are three -- law, morality, and a desire for order -- and I will touch on each of them.

<u>Law</u>

First, the legal problem. Critics often complain that regulators are "captured" by the industry they regulate. It is suggested that what is wrong is that regulators do not want to seek efficiency because their long term personal interests include getting lucrative positions with the regulated firms, positions that would be denied them if they adhered too strictly to the public interest. That is an unfair accusation. Most regulators, certainly all I have ever met, are decent people trying to do an honest job under difficult conditions. But they are

directed by law not to seek "efficiency" as economists usually define it.* Efficiency is an objective only to the extent that it is consistent with other objectives such as maintaining "the economic viability of the regulated firms" and serving the "public need and convenience." Regulators cannot, on their own, reduce the scope of regulation. They cannot allow free entry, wide latitude in rate-making, and the termination of losing (inefficient) operations without some changes in the law.

Anyone who thinks he would behave differently from the way regulators do should look into the lawsuits filed against regulatory decisions by both the regulated firms and the public. In fact, I was told rather ruefully by one regulator that he knew he had made a good decision when he was sued by both sides.

Morality

The second major impediment, what I applaud as basic morality of government, may also be called the problem of vested interests. Let me clarify what I mean by vested interest, because the term has an unfortunate connotation I want to avoid.

Regulation involves setting rules by which providers are allowed to do business. No matter how ridiculous the rules may seem, no matter how much

*Except when "natural" monopoly is involved, regulation and efficiency are contradictory, almost by definition. Efficiency is usually associated with profit seeking in the free-market and regulation intentionally interferes with both the market and profit seeking behavior.

they induce inefficiency, they are the outcome of accepted political processes and they must be considered legitimate.

To take an extreme example, consider taxicab regulation in New York City - the restriction of entry has resulted in a medallion price on the order of $25,000. No one can seriously argue that a valid social purpose is served by such a restriction. But until the rule is changed, it must be followed. If the legitimate authority restricts the number of medallions, the medallion owner may realize a capital gain but the voters are to blame, not the owner. If an entrepreneur buys a medallion for $25,000, he is doing nothing but what the law calls for, and he certainly should not be the object of opprobrium. Anyone buying a medallion is buying a right. With payment of the price, that right is vested in the buyer. What I mean by a vested interest, then, is a right that is purchased or recognized by common practice.

Such rights are created by regulation and could be extinguished by changes in regulation. I equated the problem of vested interests with morality because it is appeals to basic morality that prevent regulators from making changes that would do away with rights. Again, consider the case of the buyer of a taxi medallion. Suppose the law is changed to allow free entry into the taxi business; what will happen to his right? It will become worthless. The man who bought a medallion will have his $25,000 taken from him as surely as if he were robbed at gunpoint. I think, and I hope you all agree, that to take away a right that has

been vested, and to which people have adjusted their behavior, is immoral; it is simply unacceptable behavior for government.

Other "rights" have become viewed as "vested" although they were never sold as explicitly as medallions. They include:

1) The right of employees of regulated companies (or publicly owned transit systems) to their jobs and all the privileges associated with them.

2) The right of transit passengers to "justified rates".

3) The right of communities or neighborhoods being served to continued service.

These vested interests are not always explicitly recognized in law but Section 13c of the Urban Mass Transit Act is an example of the vesting of employee "rights".* Section 4(i) of Article XII in the Washington Metropolitan Area Transit Regulation Compact** is another explicit recognition of passenger and community vested "rights". Even where the law is vague about such rights, a regulator will ignore them at his peril. Much of regulatory law simply reflects what the public at large thinks is fair, and a regulator who subordinates concern for fairness to concern for economic efficiency will soon find his behavior circumscribed by critical lawmakers.

*Section 13c states that workers in public transit shall be compensated for any loss of employment or earnings due to experiments funded by UMTA.

**Section 4(i) states that service shall not be terminated on given routes unless such abandonment is found to be "in the public interest". The fact that continuation of service involves financial losses to the carrier is not, in itself, justification for terminating service.

One more interest, although it isn't vested in the same sense, is important: that of politicians and regulators. The ability of a politician to cater to the desires of a constituent - to get him a subsidy of some sort - is a powerful institutional support of regulation. Only politicians can change the laws and, since doing away with regulation would do away with their power, they are not likely to do so simply because someone tells them that it is for the social good.

The Desire for Order

Of all the impediments to changing regulation, the most powerful is what I perceive to be an intellectual problem. Regulation is a pervasive phenomenon despite a long history of demonstration that it benefits a relative few at great cost to a majority of the public. There must be a reason for it. Unless voters are asleep at the switch everywhere, so that owners, workers, riders, and politicians can "put something over on them," it must be that the public wants regulation. I believe they do want it because there is a basic human desire to know that someone up there is in charge; someone to complain to when things go wrong, whether it does any good or not. They want someone to bring order out of chaos. It doesn't matter that the results of regulation are disastrous in many cases, destroying the very services that are desired and preventing others from taking their place, or that chaos remains despite the regulation. What would happen if no one were in charge? How do we know that service would be provided?

Economists are rarely troubled by such questions. Their discipline focuses on the operation of markets, including markets for transport services,

and they know, as much as anyone can know, that where there is an economic demand for service, backed up by a willingness to pay the cost, the market will satisfy the demand. They cannot point out the person in the chaos of the market who will provide the service but they know that if people want a service enough to pay its cost, someone will provide it. They have faith in the market; it is their guarantee that things will work out. What's more, "working out" doesn't necessarily mean that service will be provided. If riders as a group are not willing to pay the cost of a particular service, like fixed route, fixed schedule mass transit, hard-nosed economists can accept the proposition that there should not be fixed route, fixed schedule mass transit. They know that there are substitutes of some kind, at some price, and that, if buses disappear from the streets in the absence of regulation, the public can adjust.

Unfortunately for us all, most voters don't share the economists' faith. They seem to prefer the certainty of an inefficient regulated market to the uncertainty of an efficient but unregulated one. They are not satisfied that they will be better off if alternatives to buses drive buses out of business.

In one way, they are correct. This benefit of regulation is not necessarily connected to the economic benefit since the voter who supports regulation because he thinks he can do away with uncertainty often does not even use the regulated transport service. Talk to someone who supports regulation and before you're two minutes into conversation you'll find that regulation is warranted because other people (unspecified at the start but ultimately turning out to be the poor and the

stupid) can't take care of themselves in the market place. Regulators are there to protect these other people. There is a double-barrelled intellectual benefit here: regulation is seen to provide certainty in the market and to satisfy the public that those others who need help are being taken care of. Until recently, this was true self-indulgence because the benefits could be derived at little or no cost to those who didn't use public transit. What subsidies were necessary to continue unprofitable services were extracted from transit riders patronizing profitable services. Now that municipal governments have taken over most city bus lines, the general public is being asked to provide direct subsidies, raised through taxes, and the intellectual benefit is no longer free.

The three impediments I've mentioned - legal, moral and intellectual - have effectively blocked change in the past. Anyone who sees that regulation is the source of many, if not all, of the problems of urban transportation must be willing to recognize that knowledge alone is not going to make things better. Laws are not changed easily under the best of circumstances, and whether or not you are moved by the moral issue of vested interests, the political system is responsive to them - perhaps inordinately so. Given the non-economists' intellectual discomfort with the uncertainty of the market, the prospect of change is very slim.

OVERCOMING IMPEDIMENTS

It sometimes seems that the move toward more regulation is inexorable, and, at best, we can only hope to hold back its growth. I am not quite so pessimistic about what can be done.

One way to promote progress is to try what is sometimes called paying off the vested interests but what I prefer to describe as making change palatable. A straightforward example can be made of the regulation of entry into taxicab operations in New York. Allowing entry would lead to a fall in medallion price. Such a change could be made acceptable to medallion holders by compensating them for their loss.

Unfortunately, many of those who are most enthusiastic about removing entry restrictions seem to feel that the current owners of medallions have "benefited long enough at public expense" and deserve no compensation. They want deregulation without compensation. Such an approach is impractical. Responsible government cannot "change the rules" without compensation because that kind of behavior threatens the credibility of government in carrying out all its legitimate functions.

If the call for deregulation without compensation is based on the assumption that regulated firms have "benefited long enough," it is a mistake. One can sympathize with those who, upon discovering that they have been suffering from regulation, assume that the regulated firms must have been benefiting at their expense. In fact, however, the "benefits" reaped by regulated firms are usually transitional rather than continuing. Let me explain.

The owner of a taxi can expect to earn enough to pay the driver's wages, maintenance and operating costs, and the average return on capital. If regulation restricts entry (requiring a medallion as proof of legitimacy), the value of

owning a taxi will rise; revenues will increase because of either more intensive use of the cab, or higher fares, or both. But if the value of owning a taxi increases, that will be reflected fully in the price of the medallion, which will also increase. Someone who then buys a medallion at the high price can expect to earn no more than a "normal" return - wages, maintenance and operating costs, and the average return on capital (which now includes the medallion). Whoever owns a medallion receives a benefit in the form of a capital gain when entry restrictions are tightened. Whoever buys a medallion and then finds that the medallion price remains constant gets no financial benefit from regulation.

The medallion price in New York City has been around $25,000 for years - so long that lenders accept medallions as collateral on loans. Anyone who bought a medallion at that price had to invest the cost of the cab plus the $25,000, and the revenues just cover his costs.

Overcoming the misapprehension that regulated operators have been benefiting for years at public expense would go a long way toward making change acceptable. Improvement can come about in the political arena if conflicts between groups are reduced. But so long as people feel they have been duped by the vested interest, they will prefer to fight for what is "rightfully theirs" rather than to buy out.

I have concentrated my discussion so far on regulation of taxicabs because it presents a compelling and unequivocal case. The general conclusion about

making change palatable applies equally to other vested interests, however. We don't need 13c to prove that jobs are important and that transit workers' unions would resist any change that would cost their members jobs. But the spectre of drivers, mechanics, and street supervisors being thrown out of work is somewhat overdone. There is a certain amount of labor turnover in all businesses, and while removal of regulatory constraints would result in employment reductions in existing transit companies, changes could be phased in such a way as to allow adjustment in the workforce without layoffs. Of course, that doesn't consider the interest of the union as a union. I suspect that there is no way to make reduced membership palatable to the unions' officers, even though it wouldn't necessarily affect their jobs.

It is worth pointing out that one interest group has largely disappeared from the scene: private owners of franchised municipal bus systems. Most such systems have been taken over by local governments. Regulation may or may not have been responsible for their demise, but, whatever the cause, private owners no longer have a claim on us for continued support. If entry leads to the end of publicly operated buses, the only organized interest group associated with the industry will be labor.

If the result of change is that some workers are injured, it is possible to compensate them. A precedent, other than 13c, is the Trade Adjustment Assistance Act that provides for payments beyond normal unemployment insurance for those workers hurt by removal of restrictions on imports.

Of course, compensation schemes that provide income support over time have their own dangers. Recent studies of unemployment insurance have shown that more liberal benefits lead to an increase in the average duration of unemployment. While compensation may make regulatory change palatable to labor, it's important that benefits really be tailored to injuries caused by the change, not to desires for a paid vacation.

Some analysts view 13c as being a severe constraint on experiments. I view it as quite the opposite; it makes experiments acceptable. But in fact, there are municipal bus systems in which only about 20-25 % of the cost is covered by fares collected from riders while subsidies are covering the other 75%. Under the circumstances I find it hard to see why 13c is an issue at all. Without federal help, municipalities could reduce the scale of their losing operations and use some of the current subsidies for temporary assistance to those hurt by the resulting employment reductions.

Finally, there are the subsidized riders - the passengers for whom service is continued at a loss. Opening up losing routes to competition, or subsidization of a less expensive service, would clearly be preferable to continuing such an expensive activity. Again, I'd like to stress that the few who are subsidized are supported in their claims by the public at large and it is the public that must be satisfied that the few are being treated fairly. Even operators who suffer severely from over-regulation seem to feel that regulation is required to protect the public but that it should be "good" regulation - well thought out, internally

consistent, and possibly "coordinated and integrated"; it must take care of the poor and serve the public's need for public transit. Here, again, we encounter the desire for order. It is not clear how to deal with this problem. It seems to me that among voters, the desire for regulation is characteristically associated with a belief that the decline of public transit is due to evil, aggrandizing persons. It is also associated with tremendous self-confidence, a belief that through regulation we can control events and bring the evil-doers to heel. The only ways I can think of to overcome this obstacle to change are to continually demonstrate the failures of regulation and to find examples of alternatives to regulation. That, of course, is why transport specialists are always talking about jitneys in Manila, road pricing in Singapore, and other foreign examples of success. It's true that conditions in such places are very different from those in U.S. cities, but the real issue is to show that a lack of regulation is tolerable - not that rickshaws should be introduced into downtown New York.

If anyone wants to take compensation seriously, there are some things that should be done. For one thing, it would be useful to find out how many transit workers would lose their jobs if specific regulations were changed, and how much their earnings would fall. We ought to look into the effects on bus ridership of loosening restrictions on vans, jitneys, and taxis. But most important, we must find ways to give the public some degree of satisfaction that someone is in charge without actually putting someone in authority.

I must mention one danger inherent in this approach: that if we compensate losers for any damages caused by regulatory change, the compensation process will become a moral hazard. That is, it is possible that unions, operators, and politicians will find a way to reintroduce regulation and then, when we're back where we started, they'll offer to accept another payment to get out again. This danger, while real, should not be overemphasized. If getting out is hard and, particularly, if it's expensive, people won't forget too easily. It is when getting out is easy that they will find it easy to get back in.

Regulatory reform has been sought at various levels of government for at least a generation. Reformers have gone forth with great enthusiasm, armed with proofs of how regulation operates against the public interest, only to return, vanquished by its mysterious, amorphous defender, inertia. Inertia is not amorphous however; it comprises a variety of private interests, legitimate and morally defensible. While the public interest may lie with less regulation, these legitimate interests must be dealt with. Inertia is not invincible, either, but it must be overcome by satisfying vested interests rather than by a direct attack. Ultimately this is a job for politicians, not for experts like economists, transport planners, or operators. For the experts it is appropraite to analyze the benefits and costs of regulation and argue the merits of reform. But it is important that the analyses be realistic and help the politicians in striking the appropriate bargains. If the impediments are ignored and studies concentrate solely on the desired outcome, there is little reason to believe that reform will come in our lifetimes.